Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:TL-N-3604-00
VLHamilton

date: DEC 07 2000

to: LMSB Examination
Attn: Dorothy Alden

from: Acting Associate Area Counsel (LMSB)

subject: [redacted] -- Recommendations on Opening TEFRA Examination

This memorandum responds to your request for Associate Area Counsel Advice (LMSB) regarding the following issues.

ISSUES

1. Is the determination of whether TEFRA partnerships had effectively connected income a partnership item under section 6231, requiring the determination to be made at the partnership level.

2. Is the determination of whether the partnerships receiving effectively connected income were required to withhold under section 1446 a partnership item under section 6231, requiring the determination to be made at the partnership level.

3. If the determinations should be made at the partnership level, on which partnership(s) should TEFRA examinations be opened.

4. Which return governs the statute of limitations in this case, the Form 1065 or the Form 8804.

CONCLUSIONS

1. The determination of whether TEFRA partnerships had effectively connected income is a partnership item under section 6231, requiring the determination to be made at the partnership level.

2. The determination of whether the partnerships receiving effectively connected income were required to withhold under section 1446 is a partnership item under section 6231, requiring the termination to be made at the partnership level.

3. A TEFRA proceeding should be opened on all three

partners for the [redacted] year: [redacted], [redacted] and [redacted] (the latter if you believe the distributions from [redacted] from its sale of property exceeded the partner's basis in [redacted])

4. The Form 1065 controls the statute of limitations.

FACTS

[redacted] (hereinafter "[redacted]") was closely held by [redacted] groups prior to an IPO on [redacted]. On that date, [redacted] sold [redacted] shares of common stock. [redacted], a U.S. partnership (hereinafter "[redacted]"), held the largest interest prior to the IPO, approximately [redacted] percent. [redacted] was and is owned by two U.S. partnerships: [redacted] (herein after "[redacted]"), and [redacted]. [redacted] owns approximately [redacted] percent of [redacted] and [redacted] owns [redacted] percent. The partners in [redacted] are two French corporations. [redacted]'s partners include primarily French and other foreign entities and persons, but some interests are also held by U.S. entities.

[redacted] distributed a right to receive up to $[redacted] per share of common stock to all stockholders of records of [redacted], with the maximum payable of $[redacted]. [redacted] was obligated to make such payments only to the extent it received sufficient gross proceeds upon the closing of certain real estate contracts. [redacted] made the full payment under the rights in [redacted], probably in the third quarter. We estimate that [redacted] received approximately $[redacted] in this distribution, treated by all parties as a return of capital. [redacted] had no current earnings or prior E&P.

Also on [redacted], the date of [redacted]'s IPO, [redacted] sold additional shares of [redacted]. [redacted] is reported to have received a $[redacted] in this sale. On its [redacted] Form 1965, [redacted] reported a gain of $[redacted], all of which was allocated to [redacted]. In [redacted], [redacted] distributed a total of $[redacted] to its two partners.

On [redacted], [redacted] issued a notice pursuant to Treasury Regulation § 1.897-2(h)(2), indicating that [redacted] had determined that it was not a U.S. real property holding corporation and was not one at any time during the period in which [redacted] owned stock issued by [redacted]. Upon a preliminary review of the work papers upon which this statement is based, the large case examiner believes that [redacted]'s determination that it was not a USRPHC was in error and that the Service should have an in-house engineer appraise the value of [redacted]'s assets to determine whether in fact [redacted] was a USRPHC in early [redacted].

Because [redacted] has partnerships as partners, and these

partnerships have foreign partners, all partnerships at issue are TEFRA partnerships. None of the indirect foreign partners of [redacted] reported any gain from the transactions described above in [redacted]. Nor did [redacted], [redacted] or [redacted] withhold any amounts from the distributions to the foreign partners as a result of the transactions.

ANALYSIS

Law

I.R.C. § 6221 provides that, except as otherwise provided, the tax treatment of any partnership item shall be determined at the partnership level. Section 6231(a)(1) defines the term "partnership" to mean, for purposes of the instant case, a partnership in which one of the partners is other than an individual or is a nonresident alien. Section 6231(a)(2) defines the term "partner" to mean a partner in the partnership and any other person whose income tax liability under subtitle A is determined, in whole or in part, by taking into account, directly or indirectly, partnership items of the partnership.

Section 6231(a)(3) defines the term "partnership item" as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of subtitle F, such item is more appropriately determined at the partnership level than at the partner level. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i) further defines "partnership item." As relevant here, this regulation specifies that the partnership aggregate and each partner's share of items of income, gain, loss, deduction, or credit of the partnership, items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code, are more appropriately determined at the partnership level than at the partner level and are therefore "partnership items." Treas. Reg. § 301.6231(a)(3)-1(b) provides that the term "partnership item" also includes the legal and factual determinations that underlie the determination of the amount, timing and characterization of items of, as relevant here, gain.

Under section 861(a)(5), gain from the disposition of a United States real property interest, as defined in section 897(c), is an item of gross income treated as income from sources within the United States. Section 897(a) provides that, as relevant here, gain of a nonresident alien or a foreign corporation from the disposition of a United States real property interest shall be taken into account as if the foreign taxpayer were engaged in a trade or business within the United States and

as if such gain or loss were effectively connected with such trade or business.

Section 897(c)(1)(A) defines a United States real property interest, for purposes herein, as an interest in real property and any interest in any domestic corporation unless the taxpayer establishes that such corporation was at no time a United States real property holding corporation, as relevant here, during the period during which the taxpayer held such interest.

Section 897(c)(2) defines a USRPHC as any corporation if the fair market value of its United States real property interests equals or exceeds 50 percent of the fair market value of its U.S. real property interests, its interests in real property located outside the U.S. plus any other of its assets which are used or held for use in a trade or business. Treas. Reg. § 1.897-1(e)(1)(ii) provides that for purposes of determining when a foreign person has a reporting obligation, the holder of an interest in a partnership is treated as owning a proportionate share of the U.S. real property interests held by the partnership. Section 6039C, dealing with the reporting requirements of foreign persons holding direct investments in U.S. real property interests, provides, as relevant here, that real property interests held by a partnership are treated as owned proportionately by its partners. Section 6039C(3)(A). Section 63 defines taxable income as gross income minus allowable deductions.

Section 1446 requires that if a partnership has effectively connected taxable income for any taxable year and any portion of such income is allocable under section 704 to a foreign partner, such partnership shall pay a withholding tax under this section. Section 1446(c) defines effectively connected taxable income as taxable income of the partnership which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

Sections 301(a) and (c) provide that a distribution of money made by a corporation to a shareholder with respect to its stock shall be treated as a dividend to the extent of the earnings and profits of the corporation, as a reduction of basis for that portion not a dividend, and for any distribution in excess of the adjusted basis of the stock, as a gain from the sale or exchange of property.

Issue 1.

If [redacted] is found to have been a USRPHC at the time of the [redacted] IPO, [redacted] would have effectively connected income.

In particular, the gain on the sale of the [redacted] stock sold by [redacted] on [redacted], would be effectively connected taxable income subject to U.S. federal income tax by [redacted]'s indirect partners, that is, the foreign partners of [redacted]. Sections 897(a); 897(c)(1); 897(c)(2); 63; 1446(a) and 1446(c). It was to this partnership and hence its partners that all of [redacted]'s gain from the sale of the [redacted] stock was allocated. Such income would be taxable ultimately to [redacted]'s indirect partners, the foreign partners of [redacted]. Treas. Reg. § 1.897-1(e)(1)(ii). Further, if any of the distribution made by [redacted] in [redacted] from the sale of property made in connection with the [redacted] rights offering exceeded [redacted]'s basis in [redacted], it too would be effectively connected taxable income subject to tax by the foreign partners of [redacted] and [redacted]. Sections 897(a); 897(c)(1); 63; 301(a); 301(c)(3); 1446(a)(1446(c).

In order to determine whether [redacted] has effectively connected income, it is necessary to know whether [redacted] was a USRPHC in early [redacted]. To make this determination, the Service should open TEFRA partnership proceedings on [redacted] because effectively connected income is a partnership item requiring a determination of such at the partnership level.

Congress enacted the TEFRA unified partnership audit provisions to provide a method for uniformly adjusting items of partnership income, loss, deduction or credit rather than to continue the procedures existing prior to [redacted] under which each partner's liability was determined independently. Under the TEFRA provisions, "if the tax treatment of a 'partnership item' is at issue, the statute requires the matter to be resolved at the partnership level." Maxwell v. Commissioner, 87 T.C. 783, 787 (1986). Consequently, one proceeding determines all of the partnership items with respect to a partnership. Roberts v. Commissioner, 94 T.C. 853 (1990).

In accordance with section 6221, the tax treatment of any partnership item is determined at the partnership level unless specifically provided otherwise in the unified partnership audit provisions of sections 6221 through 6233. Section 6231 defines "partnership item" as any item required to be taken into account for the partnership's taxable year under any provisions of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of subtitle F, such item is more appropriately determined at the partnership level than at the partner level. Treas. Reg. § 301.6231(a)(3)-1(a), a regulation under subtitle F, provides that the partnership aggregate and each partner's share of items of income, gains, loss, deduction or credit are partnership items more appropriately dealt with at the partnership level.

While the TEFRA partnership regulations do not specifically define "effectively connected taxable income" as a partnership item, it clearly falls within the definition of a partnership item as set forth in Treas. Reg. § 301.6231(a)(3)-1(a). In addition, the legal and factual determinations that underlie the determination of the amount, timing and characterization of effectively connected taxable income constitute partnership items within the meaning of Treas. Reg. § 301.6231(a)(3)-1(b).

Furthermore, in the instant case, there will be actual adjustments on the partnership return, which adjustments will affect the way the partners should treat the distributions for tax purposes. In particular, [redacted] reported the gain on the sale of the [redacted] stock as Schedule D investment gain, similarly reporting it on the Schedule K-1's as an item of line 4. Should [redacted] be a USRPHC, the gain from this sale would be income effectively connected with a trade or business in the United States, and hence [redacted] should have reported this gain on the Schedule 1065, line 6 or 7. Section 897(a)(1). Although we do not have the [redacted] return of [redacted], we suspect that [redacted] treated the gain from the sale of the [redacted] stock in accordance with [redacted]'s treatment. Thus, adjustments would also need to be made here on the partnership return. With respect to the possibility of the dividends from [redacted] exceeding the bases of [redacted] in its [redacted] stock, this would similarly require an adjustment on [redacted]'s returns as well as those of [redacted] and [redacted] to show gain. [redacted] did not show any of the distributions from [redacted] as income on its [redacted] Form 1065, and such treatment was followed by the upper tier partnerships.

Thus, the determination of the partnership's amount of effectively connected taxable income is a determination of the amount of gain [redacted] and [redacted] received. This determination is more appropriately made at the partnership level. Consequently, TEFRA partnership proceedings apply to the determination with respect to effectively connected income, and a TEFRA examination should be opened.

Issue 2

Further, if the examiner determines that [redacted] was in fact a USRPHC in early [redacted], then one or more of [redacted], [redacted] and [redacted] may have been required to withhold on the distributions to foreign partners under section 1446.[1] This determination also

[1] Counsel will supplement this memorandum with a final analysis supporting the application of section 1446 withholding obligations to the facts at issue. [redacted] (b)(7)a, (b)(5)(AC)

(b)(7)a, (b)(5)(AC)

(b)(7)a, (b)(5)(AC)

The withholding provisions of section 1446, however, can be applied to the transactions at issue. See Rev. Proc. 89-31, 1989-1 C.B. 895 (Withholding: Partnership income: Foreign partners). This revenue ruling at Sec. 7., 02, 2 anticipates that there may be overlap between the provisions of section 1446 and section 1445, and so provides that the withholding requirements shall not be duplicative. The applicability of section 1446 to a U.S. real property interest transaction is further bolstered by the 1988 amendments to section 1446. Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 1012(s)(1)(A), 102 Stat. 3342, 3526 (hereinafter the "Act"). Prior to 1988, section 1446(c), providing for exceptions to withholding under 1446, specifically provided in section 1446(c)(3) for the exclusion from withholding under section 1446 for those amounts withheld under section 1445. This provision arguably could have meant that section 1446 was not intended to apply to U.S. real property interest transactions. But the Act removed section 1446(c). This removal eliminated the possible argument that section 1446 was not meant to apply to U.S. real property transactions.

(b)(7)a, (b)(5)(AC)

(b)(7)a, (b)(5)(AC)

involves a "partnership item," justifying a TEFRA examination.

The Internal Revenue Code ensures the payment of taxes due to the United States from nonresident aliens, foreign partnerships and foreign corporations by requiring domestic payors to withhold taxes. Sections 1441 through 1464. For the year at issue, section 1446 requires a partnership to pay withholding tax if the partnership has effectively connected taxable income and any portion of the income is allocable to a foreign partner pursuant to section 704. The partnership must file an annual return, Form 8804, Annual Return for partnership Withholding Tax, to report the total amount of withholding tax on income of foreign partners. Section 1461 imposes liability for the tax directly on any partnership required to deduct and withhold. Partnerships which fail to comply may be subject to civil and criminal penalties.

The determination of the partnership's liability for withholding tax pursuant to section 1446 requires a determination of the effectively connected taxable income of the partnership. As discussed above, the adjustments to effectively connected taxable income in section 1446(c) are partnership items as defined in Treas. Reg. §§ 301.6231(a)(3)-1(a)(1) and -1(b). Section 1446(c) essentially defines effectively connected taxable income as the partnership's taxable income, as computed under Subchapter K, with the following adjustment, as relevant here: partnership items that are normally stated separately are included if they generate effectively connected income. Section 1446(c); Rev. Proc. 89-31, 1989-1 C.B. 895, Sec. 6.

Further, the determination of the partnerships' liabilities under section 1446 is also a TEFRA item. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v) provides that the partnership's aggregate of partnership liabilities is a partnership item. Moreover, the legislative history of section 1446 reflects that Congress considered the section 1446 withholding tax to be a partnership item. In describing the 1988 amendments to section 1446, the House Committee Report states that "this withholding tax is a partnership level-computation." H.R. Rept. No. 795, 100th Cong., 2d Sess. 291 (1988).

As the section 1446 liability is directly imposed on the partnership and the determinations with respect to effectively connected taxable income are more appropriately made at the partnership level, TEFRA partnership proceedings apply to

---

withholding obligation.

determinations with respect to section 1446.[2]

Whether there is in fact a withholding requirement on any of the partnerships, however, will depend on, first, whether [redacted] or [redacted] knew or had reason to know that [redacted]'s statement regarding its USRPHC status was incorrect. Treas. Reg. § 1.1445-5(b)(3)(iii)(B). In such case, the partnership(s) would not have been entitled to rely on the [redacted] statement and are liable for the withholding and all applicable penalties. With respect to the foreign partners of [redacted] and [redacted], even if they relied in good faith upon the statement, they are not excused from filing a return and paying any taxes and interest due thereon if the statement regarding [redacted]'s USRPHC status is found to be incorrect. Treas. Reg. 1.897-2(g)(1)(ii)(A).

Additionally, if [redacted] were a USRPHC, there would be further adjustments in that the partnerships would have had to file Form 8804 reporting their withholding tax liabilities. For purposes of the withholding tax liabilities, at least [redacted] is a nonfiler, and perhaps also [redacted] and [redacted]. The adjustment with respect to the effectively connected taxable income with respect to the Form 8804 liability is 100 percent of the amount found to be such type of income.

Issue 3

Neither [redacted] nor the two upper tier partnerships with foreign partners, [redacted] and [redacted], characterized any income on their Forms 1065 as effectively connected taxable income, nor withheld any amounts in connection with the potential [redacted] U.S. real property transactions or the [redacted] related transactions. In this situation, given the facts as we know them, a TEFRA proceeding should be opened on all three partners for the [redacted] year: [redacted], [redacted] and [redacted] (the latter if you believe the distributions from [redacted] from its sale of property exceeded [redacted]'s basis in [redacted]). The audit of [redacted] would be to determine whether there is any effectively connected income, a partnership item, that passes to the partners. While this proceeding would hold the statute of limitations open for all of the direct and indirect partners of [redacted] with respect to the issue of effectively

---

[2] [redacted] (b)(7)a, (b)(5)(AC)
(b)(7)a, (b)(5)(AC)
(b)(7)a, (b)(5)(AC).

connected income, there must also be proceedings opened on [redacted] and [redacted]. These proceedings are necessary to determine whether, if there is effectively connected income stemming from [redacted], [redacted] and [redacted] have any liability under sections 1445 and 1446.

Sections 1445 and 1446 impose a liability under subtitle A on partnerships with foreign partners. For these purposes, the partnership itself is treated as a partner under section 6231(a)(2) since, contrary to the normal situation, the Service will actually be assessing and collecting a tax against the partnership as an entity. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v) makes the liabilities of a partnership, which it is required to take into account under subtitle A, partnership items. As discussed above, partnership items must be determined through a TEFRA proceeding. As both [redacted] and [redacted] potentially have liability under section 1445 or 1446, such liabilities can only be determined in a TEFRA proceeding against [redacted] and [redacted], the partnerships that incurred such liability. Thus, the partnerships should be sent notices of the TEFRA proceedings as if they are partners in themselves.

To our knowledge, none of the foreign partners have filed any income tax returns for [redacted], so there is no limitation problem with them in any event.

Issue 4

All of the U.S. partnerships filed Form 1065's for the [redacted] tax year. None of them filed any Forms 8804. Unless the Service is able to prove under the regulations of section 897 that [redacted] did not in good faith rely on the [redacted], statement of [redacted] that it was not a USRPHC during the relevant periods, neither it nor either of the upper tier partnerships would be required to file Form 8804. Hence, for purposes of the TEFRA examination to determine whether any of the income at issue was effectively connected with a U.S. trade or business, the return for control is the Form 1065.

If you have any questions on this matter, please do not hesitate to contact us.

MICHAEL J. COOPER
Acting Associate
Area Counsel (LMSB)

By: _____
VIRGINIA L. HAMILTON
Attorney (LMSB)